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SUBJECT: PM BROWN DOES THE UNEXPECTED IN ADDRESSING
ECONOMIC PROBLEMS

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¶1. (SBU) Summary: The past 72-hours have seen dramatic political maneuvering in London to confront the deepening economic crisis. The first surprise was PM Brown's appointment of his long-time nemesis, the highly controversial figure, Peter Mandelson as business secretary, followed by the creation of a 17-member National Economic Council. Both measures are energetic steps to address the crisis, but also a reinforcement of Brown and Chancellor Alistair Darling's recent warnings of the magnitude of the crisis. UK officials publicly expressed satisfaction with the outcome of the Paris October 4th, G4 meeting. However, Germany's October 5 announcement of a purported blanket guarantee of bank deposits, following a similar step by Ireland early last week, caught UK officials off-guard, and they are now scrambling to adopt urgent measures to shore up the financial system. With the London Stock Exchange down five percent in morning trading on October 6, adoption of these pressure is even more pressing. Among steps under consideration are a taxpayer-funded recapitalization of banks and a broader government guarantee of bank deposits. End Summary.

Mandelson's appointment

¶2. (SBU) Mandelson's return to London, after three years in Brussels as Trade Commissioner, sent shockwaves throughout the political community. Brown and Mandelson have long been at odds with each other, and had reportedly not been on speaking terms until recently. Beyond personality differences, Brown, when Chancellor of the Exchequer, and Mandelson, then business secretary in the Blair government, often clashed over the direction of economic policy. Mandelson's appointment has been called his political resurrection by some political pundits. Mandelson, the once-disgraced politician forced to resign twice after charges of impropriety, is being heralded as a savior, they say, charged with helping to restore faith and confidence in the UK economic system. Mandelson will join Chancellor Darling, and 15 others, as members of the newly-created National Economic Council. (Note: Mandelson did not attend the inaugural session of the NEC. According to press reports, he was rushed to the hospital with kidney stones the morning of the 6th. End Note.)

¶3. (SBU) Dubbed by the media as a &War Council," the NEC, which met for the first time October 6, is charged with assessing and responding to the implications and the challenges of the global economic crisis and the latest developments in the commodities markets, according to a HMG press release. On a longer-term scale, it is also intended

to deal with energy supplies, employment needs, and small business creation.

¶4. (SBU) Rather than having time to assess the crisis, however, the NEC is in reaction mode after weekend events in other EU member states. Germany's purported announcement of a blanket guarantee of its banks, deposits, and Denmark's decision to the same (and Ireland's earlier in the week), has upped the pressure on the HMG to take measures that would stave off any capital flight from London to markets with a higher government deposit guarantee. While the UK raised government guarantees from 35,000 to 50,000 just last week, the amount likely will be raised further to counterbalance the measures taken by Germany and the others. (On October 6, according to the press, German Chancellor Merkel backtracked a bit, clarifying that she made a political commitment that no German savers would lose money, but did not expressly state that all deposits were guaranteed.)

UK Rescue Plan

¶5. (SBU) Just two weeks ago, the HMG insisted that no wide-ranging bailout package was under consideration. However, even before this weekend's events, HMT and BOE officials were starting to put together elements of a financial support package. After the FTSE fell five percent in the morning of October 6, to its lowest level in almost four years, the need for a rescue package heightened as the market was not reassured by the G4 talks over the weekend.

¶6. (SBU) UK authorities are focusing primarily on both the liquidity of banks and their capital. The BOE, in addition to conducting U.S. dollar-denominated auctions, is expanding the collateral accepted under BOE's liquidity operations. UK authorities are also considering, in extremis, a

taxpayer-funded recapitalization of UK banks, perhaps through the issuance of preference shares, and the provision of official funds as capital backstop for ailing banks. The government probably will introduce a new banking reform bill this week, which will replace the emergency legislation that allowed its interventions in Northern Rock and Bradford and Bingley.

¶7. (SBU) The Chancellor has ruled out any interest rate intervention and rejected calls to temporarily suspend the Bank of England's independence, during a BBC interview on October 5. Vince Cable, the Treasury spokesman for the Liberal Democrats, had urged the Chancellor to "clear the road" for large interest rates cuts by suspending the Monetary Policy Committee's mandate to keep CPI below two percent. Darling responded, saying that HMG needs to be flexible with public finances, and that he will outline, during a speech on October 8, how governments ought to react to the global shock. It is widely anticipated that Darling will relax the government's fiscal rules, which limit public debt to 40 percent of GDP, during his pre-budget report later this month.

EU Coordination

¶8. (SBU) Publicly, UK officials expressed satisfaction with the Paris October 4, G4 discussions. Prior to this weekend's meeting, UK officials told us that they were skeptical that a coordinated European meeting was possible, and even questioned if it was desirable. The quick action to bail out Fortis showed that that individual member states were capable of responding to the crisis in an adequate manner, they said. They did express outrage, though, at Ireland's unilateral action to guarantee deposits of six Irish banks, and argued that it was contrary to EU rules against national discrimination and perhaps state aid.

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